C.D. Howe Institute
Commentary

www.cdhowe.org No. 195, January 2004 ISSN 0824-8001

The Border Papers

The Prospects for Deeper North American Economic Integration:

A U.S. Perspective

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In this issue...

NAFTA left several barriers to North American economic integration intact, while the events of September 11, 2001, have raised the possibility of new difficulties for cross-border trade and investment. The NAFTA partners should address these problems through interrelated bilateral and trilateral initiatives that cover trade, energy, migration and the environment.

The Study in Brief

On its tenth anniversary, NAFTA stands as a commercial success. Dramatic increases in trade and investment have increased the efficiency of North American companies. Still, while NAFTA paved over many commercial potholes, several were left untended. Non-tariff barriers, energy, migration, labor, and environmental issues all need further attention. In addition, the tragedy of September 11, 2001, created new security challenges.

To achieve greater economic integration, big ideas that are capable of capturing attention tend to have greater success. Bundling achievable goals into a single fresh initiative will give North American integration renewed momentum. Negotiators should focus on some key objectives:

- A Common External Tariff (CET) would remove the need for costly rules-of-origin regulation, a haven for protectionism in North America.
- The United States and Canada should continue to work together to enhance energy supply, improve reliability, and meet a substantial part of demand growth with North American sources.
- NAFTA is often criticized for environmental shortcomings, especially within Mexico and along the Mexico-U.S. border. Addressing these concerns is critical to gaining U.S. support for further integration. Greater U.S. financial assistance could help Mexico clean up environmental problems on its side of the border zone.
- A joint proposal from Canada and Mexico for deeper economic integration would be more effective than a unilateral approach by Ottawa.
- Taken as a package, these initiatives could offer a practical step forward for North American integration.

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$12.00; ISBN 0-88806-621-X
ISSN 0824-8001 (print); ISSN 1703-0765 (online)

North American economic integration was proceeding apace prior to the negotiation of the North American Free Trade Agreement (NAFTA) and has deepened extensively since the trade pact took effect on January 1, 1994. Without question, NAFTA and its predecessor, the Canada-U.S. Free Trade Agreement (CUSFTA), have been commercial successes — though the aggregate gains mask adjustment problems besetting some workers and companies in each of the three countries.

While NAFTA paved over a lot of potholes obstructing regional commerce, it ignored a few big ones. The negotiators and their governments deliberately overlooked obstacles to U.S.-Canada agricultural trade, problems related to migration from Mexico, barriers to energy trade and investment, and strong disciplines on contingent protection measures — specifically, antidumping and countervailing duties, and safeguard actions responding to rapid increases in imports. Moreover, the environmental and labour side agreements contained far more promises than the three governments were prepared to deliver. And the investor-state dispute settlement mechanism (Chapter 11 of NAFTA) delivered some unexpected heartburn. In the exaggerated view of environmentalists, Chapter 11 provisions have been deployed to roll back state and provincial environmental standards.[1]

Since September 11, 2001, the NAFTA partners have had to face a new and overriding challenge: addressing the added security measures that are needed to deal with recurring terrorist threats. In response, the United States has built new speed bumps on NAFTA's superhighways and around its ports. Heightened security measures impose new burdens on NAFTA trade. During episodes when surveillance is particularly intense, they make it more costly and cumbersome to move goods and people across borders. During the rest of the year, they create a zone of uncertainty around investment in Canada and Mexico for producers whose interest is naturally greatest in serving the largest market among the three partners, that of the United States. Companies cannot know, in advance, how long shipments and business travel may be interrupted, and this unpredictability may tilt some investment decisions toward the United States.

These security taxes on NAFTA commerce pose a particular challenge to businesses that have integrated their operations on a regional basis — one of the great virtues of the trade association. The impact of security taxes has perhaps been greater on U.S.-Canada trade than on U.S.-Mexico commerce. Much of U.S.-Mexico manufacturing trade has been spurred by U.S. companies establishing plants in Mexico, seeking lower labour costs for slices of the value-added chain. Exports from maquiladoras in 2000 (about $46 billion) represented about half of total Mexican exports of manufactured goods. By contrast, much of U.S.-Canada manufacturing trade is a result of convenience, quality and capacity utilization

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1 For an evaluation of Chapter 11, see Hufbauer and Schott (2003c).

differentials. Many manufacturers, particularly in the auto industry, closely link their geographically proximate production facilities in the United States and Canada, and suffer when even temporary border delays block shipments between plants. The sources of Canadian competitive advantage in manufacturing trade thus seem more vulnerable to security interruptions than the sources of Mexican competitive advantage.

The tragedy of September 11 has given urgency to reassessing how we perceive the future course of North American economic integration. This issue has stimulated a great debate in Canada, including the Border Papers series commissioned by the C.D. Howe Institute. In the United States the aftershocks from the attacks in New York, Washington and Pennsylvania still reverberate through public discourse. Security considerations colour all aspects of regional and international relations. In North America, U.S.-Canadian cooperation has deepened as the two countries implement their Smart Border initiative (with some 35 working agendas). Similar measures have been put in place on the Mexican border.

In the United States, however, the issues of deeper economic integration have been subordinated, at least temporarily, to the immediate demands of national security. Indeed, foreign policy more than economic policy has coloured the U.S. trade agenda since September 2001: prospective partners for new free trade agreements are chosen, in large part, based on their participation in the Coalition of the Willing, or on their prospective role in combating terrorism. The end result is a U.S. focus on a broader network of trade agreements rather than a deeper NAFTA.

This new reality poses additional challenges and opportunities for North American economic integration. NAFTA provides a solid foundation for new North American initiatives. The political imperative to work together has never been greater. But melding the political, security and economic objectives of the three countries is now more complex. This paper presents — from a distinctly U.S. perspective — an assessment of the potential for deepening economic integration in North America. We start with a summary of trade and investment in North America over the past 15 years. We then examine U.S. support for NAFTA and for expanding the scope of intra-regional cooperation.

North American Trade and Investment since CUSFTA

Two-way U.S. merchandise trade with Canada jumped from C$186 billion (US$151 billion) in 1988 (the year before CUSFTA entered into force on January 1, 1989) to C$554 billion (US$353 billion) in 2002, an increase in U.S. dollar terms of 134 percent. (For the remainder of this *Commentary*, all currency figures are in U.S. dollars, unless otherwise stipulated.) By comparison, U.S. merchandise trade with non-NAFTA partners doubled in value during the same period. Two-way U.S. merchandise trade with Mexico soared from $79 billion in 1993 to $220 billion in 2002, a gain of 178 percent.

During that period, U.S. trade with non-NAFTA countries increased by 65 percent. Largely as a result of CUSFTA and NAFTA, U.S. exports to, and imports from, Canada and Mexico now account for one-third of total U.S. trade, compared with one-quarter in 1989.

CUSFTA and NAFTA have made less difference to services trade in North America.[2] For some services, notably tourism, barriers were already very low before the trade agreements were ratified. For others, such as trucking and maritime transport, the barriers were not only high, they were almost impervious to liberalization. Moreover, the number of NAFTA temporary work visas for professional workers was very small, not enough to have much effect on the recorded flows of cross-border service income. Some service sectors, notably financial services and telecommunications, were greatly liberalized by CUSFTA and NAFTA, while others were little affected.

These cross-cutting forces show up in much weaker overall services trade growth between the NAFTA partners than merchandise trade growth. Two-way U.S.-Canada services trade increased to $66 billion in 2001 from $26 billion in 1989, an increase of 93 percent. During the same period, U.S. two-way services trade with non-NAFTA countries increased 129 percent. Two-way U.S.-Mexico services trade increased to $26 billion in 2001 from $18 billion in 1993, an increase of 43 percent. During the same period, U.S. two-way services trade with non-NAFTA countries increased by 66 percent. In other words, the statistics do not reveal a strong CUSFTA or NAFTA effect on overall services trade. Of course, particular segments of services trade — for example cross-border financial transactions and telecommunications — may have increased largely because of CUSFTA and NAFTA liberalization.

The CUSFTA/NAFTA story for foreign direct investment (FDI) has yet another aspect: not much for Canada, quite a bit for Mexico. Two-way FDI stocks between Canada and the United States increased to $244 billion by year-end 2001 from $104 billion in 1989, a gain of 135 percent. Two-way FDI stocks between Mexico and the United States (mainly U.S. investment in Mexico) rose to $64 billion by year-end 2001 from $16 billion in 1993, a gain of 288 percent. By contrast, two-way U.S. FDI stocks with the rest of the world, increased by 281 percent between 1989 and 2001, and 169 percent between 1993 and 2001.

Longitudinal data on private portfolio investment are unreliable, but a few inferences can be drawn from stocks of portfolio capital as of fiscal year 2001/2002. At the end of 2001, private U.S. holdings of foreign securities, including equities, long-term and short-term debt, totaled some $2,262 billion. Of this amount, $201 billion represented claims against Canadian issuers and $48 billion represented claims against Mexican issuers. In other words, claims against Canada were 9 percent of the global total, and claims against Mexico were 2 percent. Both figures were substantially less than the share of U.S. merchandise exports destined for NAFTA partners (23 percent and 14 percent respectively). Conversely, at the end of 2002, private portfolio investment in the United States totaled $4,338 billion. Of this amount, $208 billion represented claims held by Canadian investors, and $52 billion represented claims held by Mexican investors. As shares of the relevant totals, both Canadian and Mexican investors (5 percent and 1 percent, respectively)

2 Statistics on services trade are not highly reliable. With 48 million people crossing the Canada-U.S. border each year, and with telephones and computers enabling lawyers, architects and other professionals to carry on business from their own desks, official statistics probably underestimate the exchanges taking place.

are much smaller than Canadian and Mexican exporters (18 percent and 12 percent, respectively).

To be sure, a great deal of financial integration has taken place within North America, including for example, the Manulife-John Hancock merger, the acquisition of Harris Bank by the Bank of Montreal, and the acquisition of Banamex by Citigroup. Even without massive cross-border portfolio flows, the mortgage security, equity and insurance markets should become more tightly linked — especially with the help of a pro-NAFTA regulatory environment in all three countries.

In summary, CUSFTA and NAFTA were very good for merchandise trade, while making little difference overall to services trade, though particular service industries benefited. FDI between the United States and Mexico got a clear boost from NAFTA, though the same cannot be claimed of FDI between the United States and Canada. Two-way U.S.-Canada FDI lagged significantly behind two-way U.S.-non-NAFTA FDI. If CUSFTA and NAFTA attracted FDI to Canada, it was from third countries, not the United States. Two-way U.S.-Canada and U.S.-Mexico portfolio investment stocks are not particularly large when contrasted with merchandise trade; however, the most meaningful financial integration has probably taken place through cross-border mergers and new corporate subsidiaries.

NAFTA and U.S. Trade Politics

NAFTA passed the Congress by a narrow margin in November 1993, and the rancorous ratification debate galvanized an anti-trade coalition that remains intact today. "No More NAFTAs" became a rallying cry of the alliance between far-left and far-right interest groups concerned about political, economic, and social problems in Mexico and the impact of globalization on U.S. production and employment.

A favorite sound-bite on the political circuit is "failed NAFTA". NAFTA critics cite a long list of problems with the regional pact, but they defer to political correctness in arguing that Mexicans have suffered as much, if not more, than Americans. Echoing the metaphor of Ross Perot — originator of "The Great Sucking Sound" scare — contemporary critics say they are more concerned about investment than trade. They charge that NAFTA reforms have encouraged footloose plants to leave the United States and Canada and claim that the threat of relocation has been used to deflect wage demands. The U.S. media regularly feature the plight of blue-collar workers facing downsized jobs and paychecks. Contrasting stories describe the cornucopia of multimillion-dollar salaries and luscious stock options grabbed by corporate chiefs. From time to time, the U.S. media depict the miseries of Mexican maquiladora workers and peasant farmers — juxtaposing their hard lives against the supposed promise that free trade would quickly banish poverty from Mexican cities and countryside. All these injustices are loosely associated with globalization and NAFTA. More specifically, NAFTA opponents cite an array of disappointed expectations: continued high levels of illegal immigration; slow progress on environmental problems; weak enforcement of labour standards

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and declining real wages in Mexico, and increased transshipments through Mexico of illegal drugs.

So far, the "No More NAFTAs" rallying cry has been trumped by pro-Hispanic considerations, yet anti-NAFTA reverberations still echo. Canadians must bear in mind that Republicans and Democrats alike energetically court the fastest-growing ethnic bloc — the Hispanic vote — in presidential, congressional and statehouse races. But neither Republicans nor Democrats compete for the Canadian vote. NAFTA politics in the United States are thus far more sensitive to Mexico than Canada. This does not mean that Washington necessarily answers the telephone when Mexico City calls (as President Fox can attest!). However, no major NAFTA initiative gets far before political figures ask, how it will affect the Hispanic vote? Accordingly, our *Commentary* devotes more attention to U.S.-Mexico issues than most other papers in the Border Papers series.

The "No More NAFTAs" alliance succeeded in derailing fast-track legislation and free trade talks with Chile for almost a decade until the Bush Administration could hammer together a slim congressional majority in 2002. To warm up the Congress for Trade Promotion Authority (TPA, the new name for fast track), the Administration granted dubious safeguards to the steel industry and endorsed a blockbuster farm bill that guarantees annual subsidies of $20 billion through 2008. Then, in the final push to get TPA enacted, the Administration conceded more money for Trade Adjustment Assistance, special consideration of "sensitive products", and requirements for environmental and labour provisions. The fact that the Administration had to jump through all those hoops reflects the long-term decline in public and congressional support for free trade.[3] It also points to the exceedingly sharp partisanship in the Congress, especially the House of Representatives, dating from the heyday of Speaker Newt Gingrich in the mid-1990s. The partisan mood cuts across a wide swath of economic and social issues, including social security, taxes, trade, abortion, education, and judicial appointments.

Rancor between the two political parties deepened during the congressional debate over tax cuts in 2001, and the decision by House Republican leaders not to deal with the Democrats in drafting the TPA legislation in 2002. Only 10 percent of the House Democrats voted for TPA, and the bill initially passed by a single vote. While the free-trade agreements with Chile and Singapore in 2003 attracted broader congressional support, those accords covered only modest amounts of commerce and both partners had good records on social issues. As a result, labour unions kept their powder dry for the bigger anti-trade crusades ahead.

Among think tanks and academics, NAFTA gets a rating between "strong" and "outstanding".[4] In economic terms, NAFTA has more than delivered what it promised, and most of the criticisms seek to strengthen and deepen the accord, not cut back on commitments.

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3 See, for example, Destler (1995, especially chapter 9), and Rosen (2003).

4 Illustrative Washington think tank commentaries that praise NAFTA include the following: CSIS Press Release, "NAFTA Succeeds Report: Trade Agreement Builds Institutions, Creates Jobs," (August 16, 2000); Sidney Weintraub, Op-ed Piece CSIS, "NAFTA a Politically Unpopular Success Story," (February 7, 1999); Daniel T. Griswold, CATO Institute Center for Trade Policy Studies, "NAFTA at 10: An Economic and Foreign Policy Success," December 23, 2002; John Sweeney, The Heritage Foundation, Backgrounder, "NAFTA's Three-Year Report Card: An "A" for North America's Economy," (May 16, 1997); Nora Claudia Lustig, Brookings Institution Policy Brief No. 20, "NAFTA: Setting the Record Straight," (June 1997).

The congressional debate over NAFTA ratification marked an end to bipartisan support for trade liberalization, dating from Eisenhower's presidency in the 1950s. In the 1980s, before NAFTA was on the horizon, the Democratic Party, especially in the House, was already getting more querulous about the benefits of trade liberalization. The NAFTA debate put left-wing Democrats, as well as right-wing Republicans, squarely in the camp of protectionism. Afterwards, trade became an intensely partisan issue, with lopsided House Republican majorities in favor of liberalization and lopsided House Democrat majorities against.

In the debate over Trade Promotion Authority, the eventual legislation survived in the House of Representatives by the slimmest of margins, simply because Republicans slightly outnumbered Democrats. While one less often hears the mantra of "No More NAFTAs", the political divide dating from the earlier debates remains a huge obstacle to new initiatives. A diverse alliance of political constituencies, made up of U.S. labour groups, extreme environmentalists, and conservative adherents of Ross Perot and Patrick Buchanan, still strongly opposes the integration process. At the same time, the political imperative of the Hispanic bloc means that any new initiative has to have something for Mexico.

As we mentioned earlier, NAFTA critics cite a long list of problems and disappointed expectations with the regional pact. The disappointed expectations on trade, energy, migration, labour and the environment provide, it seems to us, topics that might be included on a list of goals. They seem more likely to influence the future agenda than the exaggerated sucking-sound claims propounded by Perotistas.

Is There a Grand Bargain To Be Had?

The North American agenda is rich with proposals to support and smooth the process of integration of the three economies, a process that has proceeded in fits and starts for the past several decades. We offer a few proposals in the paragraphs that follow on key issues from the U.S. perspective.[5]

Checking the Options

A central question faced by all proposals is: what forces will catalyze political leaders to move the integration process forward? In the early 1960s, the political impetus for governmental action came from U.S. and Canadian automakers. In the early 1980s, Canadian business leaders promoted the CUSFTA. In 1990, Mexican President Carlos Salinas dared the United States to accept Mexico as an FTA partner and convinced Canada to join the ensuing trade negotiations. The impetus in 2003 comes from the doctrine of preemption. The NAFTA partners must work more closely together now, so that — in case there are additional terrorist attacks down the road — they will be less disposed to respond with knee-jerk actions that disrupt goods and people moving across borders and spawn enduring political acrimony. But preemptive preparations require economic fuel as well. The key is to

5 Goldfarb (2003b) summarizes a number of ideas proposed by other commentators for deeper integration.

find the right combination of economic and security initiatives that will spur political leaders of all three countries into action.

Hufbauer and Vega-Canovas (2003) argue that we need a common vision on NAFTA — one that builds on past successes and that posits a new agenda for a Common Frontier, involving policy convergence in areas such as customs and energy regulation, migration, and even monetary cooperation. These are issues that have long percolated in the substratum of trilateral relations, but have been deferred due to heavy resistance by powerful political constituencies in each country.

Wendy Dobson (2002) puts forward similar themes in her C.D. Howe *Commentary*, "Shaping the Future of the North American Economic Space." She argues that Canada and the United States should pursue a "strategic bargain" that would involve deepening and back-filling the existing NAFTA relationship, "without full-scale harmonization" of policies of the kind that emerge from a traditional customs-union and common-market negotiations that dilute the political independence of member countries.

According to Dobson, "Only a Big Idea is likely to attract U.S. attention." In the context of trade politics, Dobson's view draws from the experience of past GATT rounds (progressively bigger events), as well as the history of CUSFTA and NAFTA. Where small proposals foundered, large bargains eventually succeeded — not because they were easy to negotiate, but because they enlisted the attention of U.S. presidents and enabled cross-sector agreements that balanced competing political interests. Only in the last year have small bargains (bilateral FTAs with trading partners like Chile and Singapore) been in vogue — and most observers characterize these accords as warm-ups for bigger events, such as the Free Trade Agreement of the Americas (FTAA). The balance of postwar trade history still leans heavily towards Dobson's thesis of a Big Idea as the way to get noticed in Washington.

Fitting the bill, border security has certainly attracted the attention of official Washington. However, border security alone does not give Canada added leverage to negotiate reforms in U.S. policies long resistant to change. Cooperation on security cuts both ways and the alternative for Canada to cooperating with the U.S. is less efficient and more intrusive border restrictions by the United States.

Still, the border-security issue establishes a higher priority for new negotiations on an agenda of complementary economic and security concerns. In this regard, Dobson's idea of a "strategic bargain" makes sense, especially since the two countries already have extensive economic integration in autos, steel, and energy infrastructure.

To date, however, the Bush administration has given scant attention to proposals to deepen economic integration in North America — with the notable exception of border-security pacts. Big ideas have not resonated among Washington officials riveted on the Middle East, the war on terrorism, and domestic tax reform. Moreover, waffling on the U.S.-led invasion of Iraq in 2003 did not endear then-prime minister Chrétien and his government to the palace guard at the White House — despite Canadian troops risking their lives to secure the peace in Afghanistan.[6]

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6 Chrétien's policy towards Iraq owed much to the contemporaneous provincial election in Quebec, where voters were favorably attuned to French President Chirac's energetic opposition to President Bush.

Canada's new prime minister, Paul Martin, has said openly that he wants to repair relations with the U.S. But Washington's political receptivity to new Canadian initiatives will likely remain on the cool side until the November 2004 presidential election has passed.

By 2005, however, leaders in all three NAFTA countries will want to reassess their go-slow approach to regional economic integration. Under current procedures, NAFTA issues are addressed in some 30-odd committees and working groups. Without a political push from the top, it is unlikely that these tripartite committees and groups can make significant progress. Trade and investment will continue to be clouded by security concerns; economic growth in Mexico will lag behind its potential even while the United States enjoys a cyclical recovery; the region will remain vulnerable to volatile energy prices and supply shortfalls; illegal immigration will confront political leaders on both sides of the Rio Grande, and governments in all three countries will be called to task by civil society to redress labour and environmental abuses, particularly in the U.S.-Mexico border region.

For better or worse, many of these issues are linked politically. For the United States, improving prospects for economic growth in Mexico is critical to strengthening security on its southern border, while deeper cooperation with Canada on border-security initiatives is essential to ensure the efficient flow of goods and people. Mexico's economic prospects depend importantly on reforms of Mexican energy policies and extensive new foreign investment in that sector that has been barred for the past seven decades. This should be a stand-alone priority for Mexico, though political realities may require attention to the plight of Mexican migrants in the United States as an unstated quid pro quo. Plans for needed energy infrastructure investments will have to balance economic considerations, sovereignty concerns, and environmental effects. New initiatives in the areas of trade, energy, migration and finance could help deal with pressing problems in each country, while promoting closer security ties to counter the likely border-closing response to future terrorist attacks. At the same time, more could be done on the environmental and labour fronts to address the concerns of social activists. We examine in brief what might be achieved on each topic.

Deepening the Trade Bargain

The FTA, followed by NAFTA, went a long way towards removing border barriers to merchandise trade among the three countries. However, key problems have proven immune to negotiated fixes, most notably issues surrounding softwood lumber, wheat and sugar, as well as the broader questions raised by agricultural subsidies and contingent protection. Negotiators may want to tilt against these windmills again,[7] but we believe a more fruitful strategy would address a less contentious source of distortion in North American trade and investment — differences in the most-favored nation (MFN) tariffs applied against imports from third countries.

7 In our view, the disputes just mentioned, together with trucking, fisheries, avocados and several others, are best addressed through mid-level dispute-resolution procedures, with only occasional intervention from top political leaders.

One Tariff for All?

It is indeed plausible to foresee acceptance of a Common External Tariff (CET) in the NAFTA region for a wide range of merchandise by the end of this decade.[8]

As a technical matter, the NAFTA partners could move toward a CET if the two members with higher MFN tariffs would lower their rates towards the level of the member with the lowest one, gradually harmonizing their levies on industrial goods. This approach has two advantages: with proper packaging it is politically saleable as a tax cut; and it is the most direct way of eliminating the trade-deflection rationale for NAFTA rules of origin. (The record-keeping and transactions costs of meeting rules-of-origin requirements are substantial.) To be saleable in the United States, however, the CET would have to exclude key agricultural imports and it might require long phase-in periods for highly sensitive industrial products. Otherwise, the protected farmers and companies would overwhelm the tax-cut argument with cries of "giveaways to Brazil and the European Union" (agriculture) and "selling out to China" (textiles and clothing).

On trade deflection, the argument is made that rules of origin are necessary to prevent the low-tariff NAFTA member from importing goods from third countries and then re-exporting them — as is, or as components of larger assemblies — to the high-tariff members. The political, and protectionist, rationale for rules of origin is far more crass: to throw up a non-tariff barrier against imports from countries outside the trade arrangement. A common MFN tariff at least does away with the principled trade deflection rationale, giving liberal-minded trade ministers a better chance of overriding the protectionist support for rules of origin. Technically, this could be done by a NAFTA provision that says that rules of origin no longer apply after all three members get to a stage where 90 percent of their 8-digit harmonized tariff schedule (HTS) rates in any 2-digit HTS group fall within plus or minus one percentage point of the average for the three countries.[9]

It will be hard to extend a CET to the most protected and therefore most valuable agricultural markets. However desirable, we do not see U.S.-Canada talks dealing with all agricultural tariffs — much less farm quotas and subsidies — even though both countries will have to accept liberalization of farm trade barriers in the World Trade Organization and FTAA negotiations. The political problems that kept these barriers intact in the CUSFTA remain. The task of removing barriers to agricultural trade became even harder with passage of the 2002 U.S. Farm Act. A CET may be possible for selected farm products, such as brussels sprouts, apples and flaxseed. But to list the eligible products is to reveal the limitations. The dairy

8 For a discussion of the CET between Canada and the United States, see Goldfarb (2003a). Goldfarb says the CET would work to the economic advantage of both countries, though it faces a number of obstacles.

9 Within the 2-digit HTS group 87, labeled "Vehicles, Other than Railway or Tramway Rolling Stock, and Parts and Acessories Thereof", there are 68 HTS tariff lines with 8-digit identities — such items as 8701.10.00, "Pedestrian controlled tractors", and 8708.94.50, "Steering wheels for other vehicles". Under our proposal, if 90 percent of these 8-digit lines (namely 61 lines) have MFN tariff rates by the three NAFTA countries that are within one percentage point of the average for the line, then there would be no rule of origin on any item within the 2-digit HTS group. Shipments of any included item from one NAFTA member to another would clear customs with no inquiry as to where the item was originally made.

complex, field crops, cattle and pork are all beyond the scope of a CET in this decade.

As well, it is a hard political fact that the U.S. textile and clothing industries are gearing up for the fight of their lives with the prospective end of Multi-Fiber Arrangement (MFA) quotas. The industries plan at least two counter-attacks. They will confront China, India and other big suppliers with multiple safeguard and antidumping suits. Meanwhile, they will insist that any reduction or elimination of tariff barriers be concentrated in FTAs and unilateral measures like the CBI and AGOA[10] — not the WTO — and that tariff reductions be accompanied by tight rules of origin. The two industries will do their best to ensure that only fiber, yarn and cloth made within the preference zone (which excludes China, India and other major suppliers) is eligible for reduced or zero tariffs. In light of these strategies, the textile and clothing industries will resist any reduction of U.S. tariffs in a CET framework, and they will adamantly oppose the elimination of rules of origin. Because of the political muscle at work, a CET proposal will have to accommodate textile and clothing with a long phase-in period.

At the same time, movement towards a common external tariff would not address Canadian concerns about antidumping (AD) and countervailing duty (CVD) actions. In light of statements by members of Congress regarding the sanctity of existing U.S. unfair trade laws (recall that in May 2001, almost two-thirds of the Senate urged President Bush not to put U.S. antidumping laws on the table in new WTO talks), we bluntly say that Canada can almost forget about AD and CVD reform in bilateral talks. In our view, the best course is to pursue integration policies that reduce demand for AD and CVD actions rather than attempt to constrain the supply head-on.

Still, apart from the softwood lumber case — which in any event will be negotiated as a stand-alone arrangement — how important is the contingent-protection issue for Canada? Since NAFTA took effect until yearend 2002, the United States initiated 405 AD and CVD cases, but only 29 (21 AD and 8 CVD) or 7 percent against Canada. Of these cases, only 13 AD and CVD orders currently are in effect (including the current cases on softwood lumber) compared to the U.S. total of 306 AD and CVD orders.[11] Granted, the potential use of AD actions may deter Canadian companies from competing aggressively in the U.S. market. Moreover, any company considering a major new investment may be influenced, at the margin, to locate in the United States.

When NAFTA once again gets political attention, Canadian leaders will have to decide whether doing something to limit the continuing troublesome impact of the AD and CVD regimes is worth the negotiating cost and effort.[12] We believe that the best strategy for Canada and Mexico is to rely on a calibrated use of WTO and

10 The CBI is the Caribbean Basin Initiative, a one-way preference arrangement for the Caribbean islands and Central America. AGOA is the African Growth and Opportunity Act, which provides similar one-way trade preferences. Tight rules of origin on textiles and clothing are integral to both agreements.

11 As a cyclical phenomenon, there has been an increase in contingent protection since January 2000, reflecting the downturn in the U.S. economy. From January 2000 through December 2002, the United States initiated 185 AD/CVD cases, of which 21 were against Canada.

12 For further analysis, see Macrory (2002) and Hufbauer and Schott (2003c).

NAFTA dispute settlement provisions to keep U.S. AD and CVD measures in line with WTO and NAFTA obligations. In recent years, WTO panels have ruled against the United States in a number of cases (largely involving steel products) where the U.S. Commerce Department or International Trade Commission contravened WTO rules by using inappropriate methodologies to determine dumping or injury. Negotiations underway in the Doha Round of WTO talks could further clarify the procedures for conducting investigations. Meanwhile, in appropriate cases, Canada and Mexico can continue to call on NAFTA chapter 19 procedures to review final AD and CVD determinations.

A second approach would be to negotiate time-limited (say renewable every five years) sector holidays from AD duties. The holidays would be negotiated in consultation with affected industries, and would probably cover only areas that had not recently experienced a flurry of AD cases. In a sense, this proposal would codify the market demand for antidumping actions. However, sector holidays would provide a degree of assurance for new investment and plant expansion aimed at the regional market within NAFTA.

Looking a decade ahead, it seems likely that tariff and trade remedy issues will occupy less space on North American trade agenda, while domestic regulatory measures — with intended or unintended trade consequences — will become more important. Pharmaceutical trade between the United States and Canada is already a popular issue in the U.S. Congress and state legislatures; food safety and environmental standards are a perennial question, and geographic indications and other labeling issues are on the horizon. As a modest step towards mutual recognition and convergence, we suggest that leading regulatory agencies in the member countries invite senior representatives from their NAFTA counterparts to participate when they deliberate new regulations that could affect NAFTA commerce.

Going With the Energy Flow

Since September 11th, and especially since the Iraq war began, U.S. policymakers have rediscovered their latent concerns over the adequacy of North American production of oil and gas. The blackout that deprived 50 million Americans and Canadians of electricity in August 2003 underscored the problems of aging electrical transmission lines. Development of oil and gas fields, as well as construction of new energy distribution channels, is a high priority — though for somewhat different reasons — in Canada and Mexico, as well.

The Electricity Jolt

Canada and the United States have a history of cooperation on energy questions, dating to the Energy Consultative Mechanism (ECM) created in the wake of Canada's National Energy Program in 1981. Following the Northeast power blackout in August 2003, the two countries stepped up their cooperative efforts and created the U.S.-Canada Power System Outage Task Force. The mandate for the joint task force was to find out: (a) what caused the transmission system to fail; (b) why the system was not able to stop the spread of the outage, and (c) how to

prevent future power outages.[13] It was supported by experts drawn from the North American Electric Reliability Council (NERC) and the Federal Energy Regulatory Commission (FERC). Once the blackout issue was addressed, the task force was to turn its attention to the wider energy challenges facing the United States and Canada.

High on a future agenda is the common U.S., Canadian and Mexican interest in expanding regional energy production, especially production of North American natural gas. The U.S.-Canada energy infrastructure is already fairly well integrated, but distribution of supplies faces numerous obstacles both within and between countries. U.S.-Mexico energy relations are sharply constrained by the Mexican constitutional prohibition on foreign participation in the exploitation of oil and gas. Mexico must reexamine these policies if the country is to avoid a major power shortage in the coming years.[14] Unfortunately, the Mexican Congress seems reluctant to proceed on even modest reforms that could boost investment in electricity generating plants. It is even less willing to contemplate foreign energy companies playing a role in developing deep Mexican oil reserves (in the Gulf) or gas reserves (in the northern states).

What could be done? Dobson (2002) proposes a constructive starting point: use the existing bilateral and trilateral mechanisms to coordinate efforts at regulatory reforms that would encourage production and distribution of natural gas.[15]

Working together in this area seems like a no-brainer; however, the proposed projects are big and expensive, and politicians are already vying for the spoils. Witness the wrangling in the U.S. Congress over subsidies (a combination of tax breaks and floor prices) for a southern pipeline route (principally natural gas, but potentially oil as well), extending from Alaska to Chicago.[16] The proposed route would bypass the Canadian McKenzie Basin and, not surprisingly, has drawn the ire of Canadian officials and energy companies. The main reason Congress favours a southern route is to ensure more jobs for U.S. construction workers, and to use more pipe made in the United States. A supplementary argument for the southern route is to minimize environmental damage in Alaska that could arise from an underwater pipeline.

In contrast, Canadian officials believe that the alternative northern route, passing through the McKenzie Basin with an underwater link to Alaska, is preferable. They argue that "the market" should decide the pipeline route –

13 The task force has three subgroups: the Electric System Working Group, the Security Working Group, and the Nuclear Working Group. The latter complements longstanding consultations under the Canada-US Nuclear Cooperation Agreement that address commercial and non-proliferation issues.

14 In his annual Informe, President Fox noted that Mexico needs $50 billion in investment over the next decade to upgrade power generation (Washington Post, September 2, 2003, p. A16).

15 This recommendation was put forward by President Bush's task force on energy policy, and got renewed attention after the Enron crisis broke. See the comprehensive analysis by Bradley and Watkins (2003). For the purpose of advancing natural gas production and distribution, the groups created in the wake of the power outage could be consolidated into the North American Energy Group, established by the NAFTA members in 2001.

16 The environmental consequences of any pipeline from Alaska and northern Canada are huge. It seems highly unlikely that these consequences will be endured twice.

without government intervention through subsidies or regulation. However, pure market forces, without government intervention, are seldom allowed unfettered play when it comes to major energy projects—in the United States or Canada. Environmental, employment, Native American, Aboriginal and security concerns are all given a voice through public officials.[17]

If the pipeline problem can be amicably resolved, it should also be possible for the United States to include Canada in its future storage plans for strategic reserves of oil and gas. Abandoned potash mines located in Saskatchewan, and similar sites, could be used for northern reserves.

Progress with Mexico on the energy front will be more difficult. Fundamentally, there are two obstacles. The first of these is popular Mexican resistance to amend the constitutional prohibition against foreign participation. The second is Pemex and CFE workers' worries about losing their jobs. Even if the petroleum sector booms, it will not relieve the feather-bedding that accounts for huge excess employment and drives up costs in the Mexican energy sector. We think that Mexico could design transitional arrangements to guarantee the job security of many current energy-sector workers, either in their present place of employment or in new foreign ventures, then buy out others through wage insurance programs (funded by oil industry contributions), such as those recently incorporated in the U.S. Trade Act of 2002.

Even then, amending the Mexican constitution to enable limited foreign participation will be a difficult task. Indeed, we don't believe that even incremental energy reforms are saleable unless linked to other important political issues, such as migration. We recognize the political roadblocks, but suggest that Mexico will soon have little choice if its development strategies are to succeed and its growth is to reach a sustained annual rate of at least 5 percent. Necessity may be the mother of intervention.

Controls on Coming and Going

Mexico is keenly interested in the treatment accorded to migrant workers, both those already resident in the United States and those who seek entry, legally or otherwise. According to Philip Martin (2003), the number of Mexican workers employed in the United States is about 5.5 million. Annually, in the late 1990s, approximately 150,000 Mexicans entered the United States legally, mainly under family reunification visas, and 400,000 entered illegally, most in search of work.

How to be Good—Secure—Hosts

As a cooperative prologue to work on the thorny problem of migrant workers, we believe that Ottawa, Washington and Mexico City can forge common visa standards for most non-NAFTA visitors and immigrants. This goal is highly significant from a security standpoint. For people arriving from outside the

17 Canadian producers have already submitted plans for environmental assessment, and they are negotiating routing rights with aboriginal groups. These are welcome steps, but we think public money or guarantees will be required if the pipeline is to be constructed in the next decade.

NAFTA region, the North American countries need a shared system for excluding non-NAFTA nationals who pose a security threat.[18] Legal immigrants are already thoroughly scrutinized before they enter; the real problem is visitors. Annually, Canada admits about 4.4 million non-U.S. visitors, Mexico admits about 3.3 million and the United States admits about 29 million non-NAFTA visitors.[19] These numbers are 20-to-30 times larger than the annual intake of legal immigrants.

Non-NAFTA visitors who threaten security can be better excluded if a few principal measures are adopted. The NAFTA partners should agree on visa-waiver country lists, length of stay, and watch lists for potentially troublesome visitors.[20] Officials in each country should have electronic access to the immigration records of its partners. These suggestions seem obvious. However, U.S. security agencies, such as the FBI, CIA, Customs, and Alcohol, Tobacco and Firearms (ATF), have yet to agree on a common watch list for potentially troublesome visitors to the United States, so it will take political energy to forge a common North American approach.

As well, NAFTA partners should create a special force to handle all third-country immigration controls at the individual's first airport of entry into NAFTA space. Common document and biometric identification standards should be applied.

Likewise, the partners should create a more efficient system for handling legitimate travelers among the three NAFTA countries. The Smart Border Accord negotiated between Canada and the United States contains useful elements: high-tech identity cards for permanent residents, using biometric identifiers, and pre-clearance programs for frequent travelers — known as INSPASS at airports and CANPASS, dedicated commuter lanes — at land borders. The same system should be extended to cover visitors arriving from Mexico.

The most difficult problem between Mexico and the United States, but one with the highest political and economic payoff if satisfactorily resolved, is the issue of unauthorized Mexican workers. Within this category are two groups: those who already reside in the United States, numbering as many as 4.5 million in 2000,[21] and those who will, in the future, come to the United States to work. What kind of assurances could an immigration agreement provide?

The place to start is with the sustained flow of migrant workers arriving in the United States. As the economy strengthens, the United States should take up President Vicente Fox's challenge to substantially enlarge the annual quota of Mexicans legally authorized to enter the United States on temporary, renewable, work permits. In recent years, legal immigration from Mexico to the United States

18 As Rekai (2002) points out, Canada and the United States have very different systems for admitting immigrants as permanent residents. About two-thirds of Canadian immigrants are admitted on employment criteria, and one-third on family reunification grounds. The proportions for the United States are reversed. In addition, Canada has a more lenient attitude towards refugees than the United States. Canada does not keep good track of refugees after they are granted asylum, prompting U.S. concerns that some may be involved in terrorist sleeper cells.

19 Ibid.

20 As part of the Smart Border accord, Canada and the United States have already agreed to consult one another as they review their visa waiver lists.

21 See Pastor (2001) and Martin (2003).

has numbered about 130,000-to-170,000 people annually.[22] Illegal immigration figures are speculative, but Martin (2003) places the annual number at around 400,000 in the late 1990s.

One way to tackle the flow problem is to start with an expanded number of legal visas. Martin recommends a guest worker visa that could be initiated by a U.S. employer. Mexicans admitted under these visas would be refunded part of their Social Security and Unemployment Insurance payments when they returned to Mexico and surrendered the document. Perhaps 100,000 people, including unskilled workers, could be admitted from Mexico annually on a work-skill basis. However — and this is where security gets underlined — to obtain a guest worker visa, the Mexican applicant would have to undergo a background check. Moreover, the guest worker program should be renewable, say every two years, based on progress in reducing illegal crossings.

Coupled with this substantial, but closely regulated, increase in temporary work permits, the United States and Mexico should embark on a joint border patrol program to reduce the flow of illegal crossings. Of great concern to the United States is not only the migration of Mexican workers illegally, but the lack of security on Mexico's southern border with Guatemala and Belize, a passageway for illegal workers traversing from Central America. No border patrol program will eliminate illegal crossings, but a joint program could reduce the flow. Biennial renewal of the guest worker visa program should be conditioned, in our view, on progress in reducing the illegal flow.

That leaves the situation of perhaps 4.5 million unauthorized Mexicans who live and work in the United States. We do not have a magic solution. The foundation for our tentative suggestions is the proposition that these people have made permanent homes in the United States and they are not going to pack up their lives and return to Mexico. Under a set of appropriate circumstances, therefore, they should be granted residence permits with eligibility for citizenship. The appropriate circumstances we envisage have two components — a threshold relating to the total number of illegal crossings, and standards for individual applicants.

First, the resident permit program would be launched when the presidents of the United States and Mexico jointly certify every two years that the annual rate of illegal crossings — measured by border apprehensions — had not exceeded, say, 50,000 people. In recent years, the number of apprehensions has exceeded 100,000 annually, so this would entail a dramatic reduction in illegal crossings. The resident permit program would be suspended in years when the presidents could not make this certification. The same trigger should, in our view, apply to continuation of the guest worker visa program.

Individual eligibility for the residence permit would require evidence that the person resided in the United States prior to the announcement of the program. Applicants for a residence permit who could provide satisfactory evidence of residence in the United States prior to the announcement of the program would not be subject to deportation, regardless of whether they met other eligibility requirements, so long as they periodically reported a place of residence to the Immigration and Naturalization Service (INS), and committed no felony after

22 U.S. Department of Justice (2002).

getting the permit. Permit holders would be immediately eligible for Social Security and Medicare benefits, as well as for private health and pension benefits. They could apply for citizenship after five years.

As Sidney Weintraub has pointed out,[23] these proposals leave many questions unanswered. Issuing residence permits to Mexicans covertly living and working in the United States can be said to reward illegal behavior. Not issuing residence permits to Central Americans and others living and working illegally can be said to discriminate. A guest worker program that does not offer U.S. citizenship can be criticized for dangling forbidden fruit. A call for Mexican cooperation on border control raises constitutional issues. After listing these and other difficulties, it is tempting to abandon proposals for migration reform and claim, with Dr. Pangloss, that we already live in the best of all possible worlds. But our view is that piecemeal and imperfect reforms are better than letting the U.S.-Mexico migration issues fester.

Where the Buck Stops

There is scope for deeper financial cooperation within NAFTA, but little prospect for a common currency. This conclusion arises from the predominance of the U.S. economy in the region—accounting for almost 90 percent of North American GDP—and the reluctance of U.S. leaders to share control over monetary policy with their North American neighbors. Simply put, the United States would insist on calling the shots on monetary policy if the three countries got together on a common North American currency.

If Canada and Mexico wanted to have a common currency, nothing stands in their way of unilaterally adopting the U.S. dollar. But doing so would not give the two countries a say in U.S. monetary policy. As a result, a common currency is far from imminent.[24]

Instead, we recommend that the Federal Reserve Board of Governors welcome representatives of the Banco de Mexico and the Bank of Canada to join its key meetings — those where interest rate decisions are made — on a non-voting basis. Reciprocal invitations should be forthcoming from the Banco de Mexico and the Bank of Canada.

At the same time, the NAFTA partners could usefully coordinate their approaches to the regulation of financial services. Mexico has experienced a series of bank failures, while the collapse of Enron, Arthur Andersen, Global Crossing and WorldCom, followed by a string of Wall Street and CEO scandals, starkly revealed the underside of U.S. finance. Canada has a cumbersome capital market regulatory regime that is run by the provinces.[25] Mexico and the United States are both well along on their own clean-ups, though more could be done in a North

23 In comments to the authors on this paper.

24 For an extensive analysis of these issues, see Robson and Laidler (2002).

25 In the United States, the states have a regulatory role as well, but for securities, the SEC is clearly the dominant voice (as the confrontation between the SEC and NY Attorney General Eliot Spitzer showed). The state regulatory voice is strongest for insurance, an anachronism that dates to the 1930s.

American context. In Canada, the trend towards harmonized securities regulation among the provinces is long overdue. A single national entity would help even more.[26]

North American regulatory task forces should exchange views on the reform of accounting standards and corporate governance. They could provide a voice for convergent regulation of banks, insurance companies, securities firms, pension funds, mutual funds and other asset-management companies throughout North America. Mutual recognition of standards for issuing securities should command greater support, particularly in the SEC.[27] If the NAFTA members agree in principle to mutual recognition of federal standards, but not state or provincial standards, it would give a useful push to rationalization of the Canadian system.

Environment and Labour: The Weak Links

The NAFTA negotiators never intended to make substantial progress in addressing labour and environmental problems.[28] The labour side agreement is little more than a toothless list of hopes. The environmental side agreement is somewhat stronger, but no NAFTA country, especially the United States, wants intrusive surveillance of domestic environmental policies, nor was the United States willing to provide large-scale funding for needed infrastructure to clean up the Mexico-U.S. border zone. The two side agreements were weak by design, because Canada and Mexico would not have accepted side agreements that were strong enough to achieve their stated purposes, especially concerning enforcement measures.

The real purpose of the agreements was to provide political cover for Democratic members of Congress to support NAFTA. Viewed in these terms, the agreements were partially successful: NAFTA ultimately passed with the support of a fair number of congressional Democrats. However, labour unions and some NGOs have since used what they refer to as NAFTA failures as a rallying cry. Against this background it will be very difficult to assemble a political consensus within the United States for a deeper NAFTA unless new measures are taken to address labour and environmental issues. We think constructive steps are possible, as part of a larger bargain.

For one thing, it galls Mexico that trade sanctions are held out as a remedy for persistent Mexican violations of NAFTA environmental or labour obligations. To be sure, NAFTA panels have never come close to recommending trade sanctions, though the theoretical remedy is written in the side agreements. This amounts to

26 Canada's 10 provincial securities regulators have created uniform legislation and a mutual recognition ("passport") system so that securities registered in one province can be issued and traded in the other provinces. Oversight is provided by a joint body of Canadian Securities Administrators.

27 Since 1991, the Canadian provinces and the SEC have had a system for mutual recognition of prospectuses and other disclosure materials, known as the Multi Jurisdictional Disclosure System (MJDS). In the wake of the Enron debacle and other Wall Street scandals, however, the SEC has not devoted bureaucratic resources to updating the MJDS and coordinating the evolution of financial standards.

28 For a more comprehensive treatment of the two side agreements, see Hufbauer and Schott (2003a, 2003b).

discriminatory deterrence. The United States agreed on monetary fines as the remedy for Canadian violations, and it also agreed on monetary fines as the remedy of first recourse in the U.S.-Chile and U.S.-Singapore FTAs.[29] As part of the new package, the United States should align NAFTA procedures with those in its new FTAs and agree to monetary fines as the ultimate remedy for Mexican violations.

Second, U.S. labour advocates object that Mexico does not effectively enforce core labour standards. The U.S. definition of core standards differs somewhat from the International Labour Organization (ILO) definition, though they have four elements in common: freedom of association; the right to organize and bargain collectively; freedom from coerced labour, and prohibitions against the worst forms of child labour. We think Mexico, as well as Canada and the United States, could agree to establish effective labour tribunals to enforce these four rights, with NAFTA oversight on an expeditious and non-political basis. From the standpoint of trade politics, this reform should be highly valued by U.S. labour unions, and should more than compensate for the loss of trade sanctions.

Third, U.S. and Mexican environmental groups are rightly distressed that so little has been achieved in improving the day-to-day environment in the border zone and many cities in the interior of Mexico. Fears of NAFTA critics that the pact would spur the downward harmonization of environmental and public health standards, and create pollution havens in Mexico, were imaginary bogeymen that have not come out of the attic. But progress to date pales in comparison to environmental problems that were decades in the making. The missing ingredient is money – the North American Development Bank (NADBank) is woefully underfunded, and Mexican municipalities are starved of revenue. We think the answer is a matching program. The NADBank's capital base should be increased to $10 billion from $4.5 billion. Instead of a 50-50 split between the United States and Mexico, the funding should be 75-25. For its part, the Mexican government should assist municipalities in levying and collecting property taxes, and dedicate the revenues to environmental improvements in such basic services as water, sanitation, and paved roads. In 2000, Mexican property taxes were just 0.3 percent of GDP, compared to 3.0 percent in the United States and 3.5 percent in Canada.[30] NADBank loans for municipal environmental projects should be conditioned on a significant local tax effort.

Fourth, the NAFTA members should renegotiate the language of Chapter 11. As we have explained elsewhere,[31] Chapter 11 arbitrations in investor-state disputes have not resulted in the rollback of state and provincial environmental standards. However, sentiment is widespread in the environmental community that past and future arbitration awards will have just this result. The remedy, we think, is to align the NAFTA text with the language adopted in the U.S.-Chile FTA, where the "tantamount-to-expropriation" test is revised and the arbitration procedures are more transparent.

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29 Trade sanctions are an ultimate, and highly theoretic, backup remedy in the U.S.-Chile and U.S.-Singapore FTAs.

30 OECD (2002, table 22).

31 See Hufbauer and Schott (2003c).

Conclusion

What does this all add up to? In the near term, the agenda for North American integration is likely to be more limited than the ambitious vision of Dobson's "strategic bargain". The United States will remain focused primarily on security issues, and to a lesser extent on energy policy. In addition, it has a bilateral agenda with Mexico on key migration issues. In terms of trade initiatives, the three countries of North America probably will pay most attention, in the next two years, to the broad-based initiatives in the WTO and the Free Trade Area of the Americas.

However, in the wake of the failed Cancun Ministerial, there is an increasing risk of failure in the WTO and FTAA ventures because of political resistance to reform of longstanding EU and U.S. trade protection measures and strident insistence by the developing countries that the OECD countries should liberalize on a non-reciprocal basis. Barriers that have survived the eight previous rounds of multilateral trade negotiations are the ones that are the most politically entrenched: textiles, clothing, agriculture, and services. Europe and the United States have shown their reluctance to liberalize these areas; so have key developing countries such as Brazil, India, Indonesia, and South Africa. The European Union recently announced a policy of partial decoupling of agricultural subsidies, but with a loophole for re-coupling if too many farmers go out of business. Last year, the White House clawed back textile trade preferences for countries in the Caribbean Basin to buy a decisive vote for the Trade Promotion Authority bill. Recent EU and U.S. actions are not promising, and proposals on the table are tepid, but failure to reform their longstanding barriers would greatly complicate efforts to reach an agreement that commands the support of developing countries. At the same time, insistence by major developing countries that they can retain their high manufacturing tariffs, prohibitive service barriers, and agricultural protection while OECD countries unilaterally embrace the teachings of Adam Smith does not point to productive negotiations.

If the WTO and FTAA negotiations seize up or stall, then the United States might refocus its trade policy efforts on the immediate neighbourhood. Because of the continuing strong U.S. interest in bolstering regional security, the broader trade and economic agenda would then be given a much higher political profile—increasing prospects for concluding a strategic bargain in North America.

As was the case with CUSFTA and NAFTA, initiatives will have to come from Canada and Mexico. While Canadians might argue that economics justifies a bilateral arrangement, U.S. domestic politics makes Mexican participation imperative. But timing is critical. Relations between George Bush and Prime Minister Paul Martin seem better than those between Bush and Chrétien, while those between the U.S. leader and Vicente Fox remain strained. In any event, the Bush administration will remain preoccupied with domestic politics, Iraq, and the war on terrorism through the U.S. election in November. The narrow window for deepening NAFTA probably won't open until early 2005 and could close soon after.

In the interim, it makes sense for the Prime Minister of Canada and the President of Mexico to try to reach agreement on their own major agenda items and then make a joint démarche to Washington. Then, it would be harder for the U.S. president who is inaugurated in January 2005 to ignore the invitation for serious talks. Indeed, it is entirely possible that the president would welcome a friendly North American initiative, especially if the WTO and the FTAA are bogged down and the Middle East looks like a long and difficult slog.

However, if either Canada or Mexico makes a separate approach, the initiative could get sidetracked as the U.S. president focuses on global priorities. Immediately after September 11, 2001, North American security pacts commanded high-level political attention. But in early 2005, new Canadian proposals to craft a strategic bargain might not seem as salient to the White House. One bilateral proposal that might jolt Washington into action would be a Mexican offer to link energy and migration reforms. But that proposal seems unlikely because of the current constellation of political forces in Mexico and President Fox's weak support in the Mexican Congress.

Could the U.S. border states that are most directly affected by economic integration with Canada provide the needed impetus for a bilateral bargain? Probably not. The agenda that we have posited largely involves areas of federal jurisdiction. The influence of northern border states seems muted on trade issues. If they acted in concert, the big northern border states – Washington, Illinois, Michigan and New York – could make a difference, but so far there is little evidence that they will actively advocate deeper integration. This is in stark contrast to the power and influence of the two key states on the Mexican border, Texas and California. The southern border states do not speak with the same voice on relations with Mexico, but when they do speak their voices are heard.

In this *Commentary*, we have offered more than enough advice on the substance of a North American initiative. Our recommendations will be too bold for some readers, too timid for others, misdirected for some, and just right for a select few. As important as the contents of a new package, however, is its wrapping. If the Canadian Prime Minister decides it is worth the risk to put a major proposal on the table, our suggestion is that he first visit Mexico City and do everything possible to enlist President Fox as the co-sponsor. Together, the two leaders should then engage the U.S. president. If the proposal gets lost in the Washington mist, Canada cannot be blamed for getting too far ahead. If serious talks get underway, Canada and Mexico will have the advantage of reading from the same chapter, if not the same page.

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"The Border Papers" is a project on Canada's choices regarding North American integration. It is produced with financial support from the Donner Canadian Foundation and guidance from an advisory board, with members drawn from business and research organizations.

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The Institute began life in 1958 when a group of prominent business and labour leaders organized the Private Planning Association of Canada to research and promote educational activities on issues related to public economic and social policy. The PPAC renamed itself the C.D. Howe Research Institute in 1973 following a merger with the C.D. Howe Memorial Foundation, an organization created in 1961 to memorialize the Right Honourable Clarence Decatur Howe. In 1981, the Institute adopted its current name after the Memorial Foundation again became a separate entity in order to focus its work more directly on memorializing C.D. Howe. The C.D. Howe Institute will celebrate its 50th Anniversary as the gold standard for public-policy research in 2008.

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